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SENATE REPUBLICAN POLICY COMMITTEE

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Democrats' PAYGO Will Not Restore Fiscal Responsibility

Executive Summary

- Republicans stand for keeping taxes low and limiting spending to the most critical priorities. As such, they support budget enforcement tools to help them achieve these goals.
- Democrats, on the other hand, tend to support programs that grow government through spending proposals paid for with tax increases. As such, they support the tools that help achieve that end.
- Are Democrats using PAYGO as a means to describe their tax-and-spend agenda as deficit reduction?
- PAYGO, in its various incarnations, reflect the priorities of each party. Democrats argue that their PAYGO proposal in S. 10 is a tool to enforce budget discipline. In reality, Democrats' PAYGO, or more aptly called Tax-Go, is a roadblock to extending the 2001 and 2003 tax cuts, from which every American is benefiting.
- Republicans support the existing PAYGO, which helps assure that spending and taxing policies mirror the agreed upon budget resolution.
- Democrats label their PAYGO bill the Restoring Fiscal Discipline Act. Yet it will not apply to any existing mandatory entitlement programs.
- Democrats' PAYGO uses a flawed budget baseline, which results in a prejudice against tax cuts.

Introduction

Republicans will long remember the 1990 Andrews Air Force Base Budget Summit as the means by which a Democrat Congress convinced President George H.W. Bush to break his pledge not to raise taxes. In addition to the actual tax increases, that budget agreement also included the Pay-As-You-Go (PAYGO) provision, hailed by some as key to restoring fiscal discipline. Seventeen years later, Democrats continue to hail this device, introducing a revised PAYGO budget rule as one of their "top ten" agenda items (see S. 10 and H.Res. 6) and framing it as a key pillar in their plan to "restore fiscal discipline."

While "pay-as-you-go" certainly sounds like good fiscal discipline, and so does the bill's title – Restoring Fiscal Discipline Act of 2007 — Democrats' proposed PAYGO rule will not make good on its promise to restore fiscal discipline. What it will do is to make it nearly impossible to extend the tax relief provided by Republicans in 2001 and 2003. That tax relief includes the 10-percent bracket, increased child tax credit, and marriage-penalty relief. Meanwhile, it ignores the number one fiscal-discipline problem facing lawmakers – existing mandatory entitlement spending. Additionally, PAYGO has a technical flaw in its relationship with the baseline that results in a prejudice against extending tax cuts.

Republicans want comprehensive budget process reform that will result in fiscal discipline, but must reject any – like this one – that describes a tax-and-spend agenda as deficit reduction, and that are overtly biased against tax relief. In spite of the baseline problem with PAYGO, Republicans favor maintaining the current Senate PAYGO rule, as well as enacting comprehensive budget process reform that includes an automatic spending reduction mechanism through reconciliation to target growing deficits.

This paper will describe the various PAYGO proposals, including the original 1990 provision, the current Senate point of order, and the Democrats' current proposal. It will also explain the limitations of PAYGO and how it alone will not restore fiscal discipline.

PAYGO History and Mechanics

"Old-fashioned" PAYGO: Ineffective and Over-Hyped

In the face of a looming budget crisis, Congress and the first President Bush negotiated a new and comprehensive budget agreement at Andrews Air Force Base, resulting in the passage of the Budget Enforcement Act of 1990. One of the Act's most notable features was the creation of PAYGO requirements, which mandated that any *new* changes to direct (mandatory) spending and revenue legislation must not increase the deficit. Old-fashioned PAYGO, as this initial version of PAYGO is often called, required OMB to keep a scorecard of all direct spending and revenue legislation measured relative to the baseline. If the scorecard had a positive balance (that is, increased the deficit) at the end of the year, OMB was required to sequester (that is, cancel) funds from *non-exempt* mandatory programs. This version of PAYGO expired in 2002.

How often was a sequester— the enforcement mechanism of old-fashioned PAYGO— used? In the 12 years it was in effect, not a single sequester ever occurred. As a matter of fact, Congress and the President intervened on six separate occasions to avoid a sequester (and sometimes legislation that would have triggered a sequester included language saying it would not count for PAYGO).[1] Many Democrats who now argue that PAYGO is critical to budget discipline frequently voted to cancel or prevent a sequester.

Not only were sequesters regularly avoided, the statute exempted many programs from even being subject to sequester. For example, in 2002, the universe of budgetary resources available for sequestration was only $31 billion, or 3 percent, of all mandatory programs. This meant that, barring any other action, if the scorecard contained a balance (that is, a deficit) of $125 billion at the end of the year, only $31 billion could be sequestered with the remaining balance of $94 billion being carried over to the next year.

Why was such a small amount of the budget subject to sequester? One possible explanation is that PAYGO was never intended to sequester funds but rather to create a tool to force new programs to be offset by tax increases or mandatory entitlement cuts elsewhere in the federal budget. Given the option of increasing taxes or cutting entitlement programs, Democrats will nearly always choose tax hikes.

The strongest evidence Democrats offer in support of old-fashioned PAYGO is based upon faulty logic—that is, that its existence resulted in the reduction of the budget deficit. Supporters of old-fashioned PAYGO argue that it contributed to deficit reduction in the 1990s, resulting in a budget surplus by 1998. Such proponents fail to acknowledge that a growing economy drove up tax receipts by an average annual rate of 4.2 percent throughout the 1990s. In addition, defense spending dropped throughout the 1990s as Congress steadily reduced appropriations for defense in real terms.

A fundamental problem with old-fashioned PAYGO (as with all forms of PAYGO) is that a dollar of tax cuts is treated the same as a dollar of spending cuts. Old-fashioned PAYGO supporters would need to ignore both a recent Treasury Department report, "A Dynamic Analysis of Permanent Extension of the President's tax relief," and recent economic literature which finds that many tax cuts encourage productive economic activity and a resulting increase in federal tax receipts.[2]

Current Senate PAYGO Rules

While old-fashioned PAYGO was allowed to expire in 2002, the Senate is not without a PAYGO tool. The current version of PAYGO is currently known as post-policy PAYGO.

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[1] http://www.congress.gov/erp/rl/pdf/RL31155.pdf

[2] Martin Feldstein, The Effect of Taxes on Efficiency and Growth (Cambridge, Mass.: National Bureau of Economic Research, 2006). And Gregory Mankiw and Matthew Weinzierl, Dynamic Scoring: A Back-of-the-Envelope Guide (Cambridge, Mass.: NBER, 2006).

Unlike old-fashioned PAYGO, which relied on enforcement that never happened, post-policy PAYGO relies on a more effective and more immediate tool—a budget point of order. In order to enforce a budget point of order, a Member must raise a point of order against the legislation violating it. As with many other budget points of order, it takes 60 votes to waive the PAYGO point of order.

Some form of a Senate PAYGO point of order has been in effect since 1993. Post-policy PAYGO, the latest iteration of the Senate PAYGO points of order, was created in the 2004 Budget Resolution and prohibits the consideration of revenue measures or new mandatory programs that would increase the deficit by more than the level allowed by the budget resolution. Post-policy PAYGO is designed to enforce the fiscal policy parameters embodied in the budget resolution. Under post-policy PAYGO, Congress first agrees upon spending and revenue levels in the budget resolution. Once a budget resolution is set, post-policy PAYGO applies to all spending increases or tax cuts above the level agreed, thus making the budget resolution more meaningful.

Post-policy PAYGO serves a valuable purpose: it makes it difficult to increase the deficit any more than what Members of Congress agreed to in the budget resolution. The current rule follows the budget blueprint established in the budget resolution. Recent Budget Resolutions, under the GOP, have allowed for tax relief while restricting spending growth. Republicans recognize that the combination of tax relief, coupled with restrictions on spending growth, has proven to be the most effective means of reducing the deficit and encouraging economic growth. Only the current PAYGO rule affords just that while the Democrats' proposal will not.

Democrats' PAYGO Should Be Called Tax-Go

In S. 10, Democrats are proposing that PAYGO be applied to any measure that worsens the budget deficit, even if the deficit increase is assumed in the budget resolution. This differs from the current version of the PAYGO point of order, which applies only against measures that make the budget deficit *higher than the deficit level assumed in the budget resolution.* A Democratic version of PAYGO would require 60 votes to cut taxes or extend tax cuts if the PAYGO point of order is raised. This is in sharp contrast with the current post-policy PAYGO, which allows a simple majority to enact tax cuts equal to the amount of deficit increase assumed in the budget resolution.

If the Democrats' version of PAYGO had been in place in 2001 or 2003, Congress would not have been able to enact tax cuts because of the 60-vote threshold. Democrat PAYGO should be called Tax-Go because it is an effective roadblock to extending tax cuts with a Democrat majority in the Senate.

Three Versions of PAYGO			
	Old-fashioned PAYGO (sequester)	**Post-policy PAYGO (point of order)**	**Democrats' PAYGO proposal (point of order)**
Status	Expired in 2002	In effect	Introduced in the 110th Congress as S. 10
Origin	Created in the 1990 Budget Enforcement Act	Created in the FY 2004 Budget Resolution	Proposed
Trigger	All new mandatory spending programs and revenue measures must be offset or face a sequester	New mandatory spending programs and revenue measures that are above the budget deficit assumed in the budget resolution must be offset	All new mandatory spending programs and revenue measures must be offset— even if agreed to in the budget resolution
Extending tax relief	N/A	Would be possible to make tax relief permanent with a simple majority if cuts are agreed upon in the budget resolution	If not offset, would require 60-votes to waive the point of order
Enforcement	Sequester	60-vote point of order	60-vote point of order
Number of times invoked	Sequester triggered 6 times	Point of order raised 4 times	
Number of times successful	Sequester ordered 0 times	Point of order sustained 3 times	

Democrats' PAYGO Will Fail to Achieve "Fiscal Responsibility"

Despite claims to the contrary, pay-as-you-go will not achieve fiscal responsibility. The primary reason is that PAYGO ignores all existing mandatory entitlements. In addition, PAYGO operates off of an unfair baseline that is biased against tax cuts.

PAYGO rules do not apply to existing mandatory programs, which make up over 55 percent of the federal budget; rather, rules only apply to *new* programs relative to the baseline. And so, PAYGO allows Democrats to ignore the unsustainable growth of Medicare, Medicaid, and Social Security while waving a banner of fiscal discipline. Without any changes, mandatory entitlements are estimated to increase federal spending to almost 38 percent of GDP by 2050, up from 21 percent today. Even if Democrats' PAYGO is in place for the next 35 years, OMB estimates that all federal tax revenues will be used to pay for entitlements and net interest by

2040. This is because PAYGO does absolutely nothing to force a reexamination of most past spending policy decisions that are set to expire.

A PAYGO Problem: The Baseline

One of the flaws of all forms of PAYGO deals with its interaction with the baseline. All forms of PAYGO evaluate legislative proposals relative to the baseline. For example, post-policy PAYGO is based upon measuring the budgetary effects of a proposal relative to the CBO baseline, which is an estimate of federal spending and receipts during a fiscal year under existing policies. While this may seem fair enough, questionable rules govern the construction of the baseline.[3] Notably, there is a disparate treatment between taxes and some mandatory spending programs. The baseline assumes that nearly all mandatory programs that are scheduled to expire continue in the baseline forever. In contrast, most revenue provisions that are scheduled to expire in law are likewise assumed to expire in the baseline. Thus, a bill to extend certain expiring mandatory programs does *not* incur a PAYGO hurdle, while a bill to extend existing tax relief does.

	Change in Spending Relative to Current Law	Change in Spending Relative to "Baseline"
Welfare reform	+ $ 98 billion over 5 years	$ 0
15% Rate on cap gains	+ $ 21 billion	+ $ 21 billion

For example, compare the treatment of extending the 15-percent rate on capital gains and dividends with extending welfare reform. Although the 2005 extension of welfare reform would cost an estimated $98 billion over five years, relative to the baseline it would cost $0. Therefore, PAYGO did not apply. In contrast, extending the 15-percent rate on capital gains and dividends is estimated to reduce revenues by nearly $21 billion. This amount does *not* include the broad economic effects which dynamic analysis captures.[4] Because the baseline does not assume expiring tax cuts are extended, this provision would be assumed to cost a full $21 billion relative to the baseline. Therefore, PAYGO would apply, and a supermajority (60 votes) would be required to pass this bill under the Democrats' version of PAYGO. Under this disparate— and clearly biased— treatment, Congress would have to find savings to pay for the extension of tax relief but not the extension of many expiring mandatory programs.

As discussed above, the Democrats' PAYGO creates an additional roadblock for extending the 2001 and 2003 tax breaks— cuts which resulted in an 11.8 percent increase in revenues in fiscal year 2006. In addition to the technical problems with the baseline, PAYGO is based upon the faulty assumption that a dollar of tax relief is equal to a dollar of government

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[3] Baseline scoring rules have been set out in law since 1990. Because those rules have expired, the House and Senate Budget Committee Chairman may change the rules governing the baseline.
[4] For more information on dynamic analysis, see RPC Policy Paper, "Dynamic Analysis of Republican Tax Policies," September 26, 2006. Also see, Treasury Department report, "A Dynamic Analysis of Permanent Extension of the President's Tax Relief," July 25, 2006.

spending. Recent economic research indicates that the economy loses much more than one dollar when the government increases taxes by one additional dollar.[5] Two studies published this past year found an enormous economic response to a change in taxes based solely on capital.[6]

Conclusion

The Democrat's PAYGO proposal, while appearing fiscally responsible, supports a tax-and-spend philosophy. In fact, Democrat's PAYGO, like all forms of PAYGO, does not enforce any discipline on existing mandatory entitlements that grow automatically. By design, the Democrat PAYGO proposal makes it more difficult to extend the 2001 and 2003 tax measures from which all hardworking Americans are benefiting.

Summary of Additional Views

To help understand the context of the types of arguments expected during a debate of PAYGO, the following paragraph summarizes the major arguments for the Democrat version of PAYGO.

Proponents of Democrats' PAYGO will likely argue that the budget surpluses of the 1990s were a result of PAYGO. Proponents will also argue that one dollar of taxes has the same effect on the economy and the deficit as one dollar of government spending. Given this assumption, proponents contend that every dollar of tax relief should be offset with a dollar of tax relief or benefit cut elsewhere in the budget.

[5] The Effect of Taxes on Efficiency and Growth, May 2006, Martin Feldstein.
[6] Martin Feldstein, The Effect of Taxes on Efficiency and Growth (Cambridge, Mass.: National Bureau of Economic Research, 2006). And Gregory Mankiw and Matthew Weinzierl, Dynamic Scoring: A Back-of-the-Envelope Guide (Cambridge, Mass.: NBER, 2006).